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Limited Partnership—Limited Control Through a Corporate General Partner—Frigidaire Sales Corp. v. Union Properties, Inc., 88 Wn. 2d 400, 562 P.2d 244 (1977)

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LIMITED PARTNERSHIP—LIMITED CONTROL THROUGH A CORPORATE GENERAL PARTNER—*Frigidaire Sales Corp. v. Union Properties, Inc.*, 88 Wn. 2d 400, 562 P.2d 244 (1977).

Plaintiff entered into a contract to sell appliances to a limited partnership.¹ The contract was signed on behalf of the limited partnership by two officers of its corporate general partner. The officers each owned fifty percent of the outstanding shares of the corporation. In addition, they each held a limited partner's unit in the limited partnership.² When the partnership failed to pay installments due, plaintiff brought an action against the corporate general partner³ and against its two officers as individuals. The assertion of personal liability was based on a provision of the limited partnership statute under which limited partners may be regarded as general partners with general liability if it is shown that they have taken part in control of the partnership.⁴ Held, when limited partners control the day-to-day business op-

1. The first limited partnership act in the United States was adopted by New York in 1822. Nearly all states followed the New York example. See Lewis, *The Uniform Limited Partnership Act*, 65 PA. L. REV. 715, 716 (1917). Narrow judicial construction of the limited partnership statutes resulted in frequent imposition of personal liability despite substantial compliance with the requirements of the statutes. To remedy this problem the National Conference of Commissioners on Uniform State Laws proposed the Uniform Limited Partnership Act in 1916. 6 UNIFORM LAWS ANNOTATED 114 (Supp. 1978) (Commissioners' Prefatory Note). See generally Lewis, *supra* at 720-23; Comment, *The Limited Partnership*, 45 YALE L.J. 895, 899 (1936). The original uniform act has been adopted by all states except Louisiana. 6 UNIFORM LAWS ANNOTATED 94 (Supp. 1978). Washington adopted the Uniform Act in 1945 and revised it in 1972. WASH. REV. CODE §§ 25.08.010-.310 (1976). A revised Uniform Limited Partnership Act was approved by the National Conference in 1976. 6 UNIFORM LAWS ANNOTATED 114 (Supp. 1978) (Commissioners' Prefatory Note). See *Symposium: Limited Partnership Act*, 9 ST. MARY'S L.J. 441-524 (1978).

Formation of a limited partnership under either the Washington statute or the Uniform Act requires a minimum of one limited and one general partner. General partners have the attributes of partners in general partnerships: unlimited liability and freedom to act in the name of the partnership. Limited partners have limited liability but acquire the general liability of general partners if found to take part in control of the partnership. See generally A. BROMBERG, CRANE AND BROMBERG ON PARTNERSHIP § 26 (1968); H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES §§ 28-36 (2d ed. 1970).

2. There were 52 such units outstanding. *Frigidaire Sales Corp. v. Union Properties, Inc.*, 14 Wn. App. 634, 636, 544 P.2d 781, 782 (1975), *aff'd*, 88 Wn. 2d 400, 562 P.2d 244 (1977).

3. Judgment was entered in favor of plaintiff against the corporate general partner. *Id.*

4. The statute provides as follows: "A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as limited partner, he takes part in the control of the business." WASH. REV. CODE § 25.08.070(1) (1976).

erations of a limited partnership through their positions as officers of the corporate general partner, such control does not produce personal liability for the debts of the partnership. *Frigidaire Sales Corp. v. Union Properties, Inc.*, 88 Wn. 2d 400, 562 P.2d 244 (1977).

Historically, the limited partner's privilege of limited liability has been conditioned upon his abstention from active participation in the conduct of the business.⁵ The increased use of corporations as general partners has presented the question whether a limited partner's control through a position in the corporate general partner should eliminate the privilege of limited liability. The Washington Supreme Court, distinguishing a contrary decision in another jurisdiction,⁶ decided that a finding of such control does not warrant denial of the privilege. The court would impose personal liability on a limited partner acting as an officer of the corporate general partner only if some equitable ground independent of actual control mandated such a result. The practical effect of the decision is that there will be relatively few situations in which limited partners exercising control of a limited partnership through control of its corporate general partner will be held personally liable for the debts of the partnership.⁷ In view of the typical use of the modern limited partnership,⁸ the outcome of *Frigidaire Sales* reinforces the protection of limited liability for individuals motivated by the desire to reduce income tax liabilities and decreases protection for persons extending credit to those individuals.

5. Statutes enacted prior to the Uniform Limited Partnership Act penalized limited partner "interference" with the operation of the business with conversion to general partner status. See Burdick, *Limited Partnerships in America and England*, 6 MICH. L. REV. 525, 530-31 (1906); *The Limited Partnership*, *supra* note 1, at 898-99.

6. In *Delaney v. Fidelity Lease Ltd.*, 526 S.W.2d 543 (Tex. 1975), the Texas Supreme Court applied an identical statute to a similar factual pattern and reached a result opposite to that of *Frigidaire Sales*. The Washington Supreme Court distinguished *Delaney* on two grounds: Texas had not yet decided whether corporations were acceptable as general partners in limited partnerships, and the corporate general partner in *Delaney* was set up contemporaneously with the limited partnership with operation of the partnership as its sole purpose. The propriety of a corporate general partner in Washington was confirmed by the legislature in 1972. See notes 18-20 and accompanying text *infra*. In *Frigidaire Sales* the corporate general partner operated several limited partnerships, therefore its officers managed the corporation with purposes other than the sole benefit of the named limited partnership. 88 Wn. 2d at 403-04, 562 P.2d at 246. Concerning the first ground, the Texas court explicitly stated that the question of the propriety of a corporate general partner was unrelated to its decision. 526 S.W.2d at 546. With respect to the second factor, the number of limited partnerships controlled by the corporate general partner appears to be irrelevant to a determination of limited partner "control" for purposes of the limited partnership statute. See note 20 *infra*.

7. See notes 28-33 and accompanying text *infra*.

8. See notes 36-38 and accompanying text *infra*.

I. THE COURT'S REASONING

Although the court refused to impose liability in this case, it suggested that it would do so in a similar situation if additional considerations were present. Personal liability could be established either through the corporate law doctrine of disregard of corporate entity⁹ or under the court's narrow interpretation of the limited partnership statute. The court identified various theories underlying the doctrine of disregard which would justify the imposition of personal liability. First, the court might disregard the corporate entity if it found the corporation to be inadequately capitalized.¹⁰ Second, the corporate entity might be disregarded if individuals in control of the corporate general partner failed to keep the business of the corporation separate from their personal affairs.¹¹ Generally, the perpetration of fraud or manifest injustice on persons dealing with the corporation would justify imposing personal liability.¹²

The court next examined the operation of the limited partnership statute. The statute treats limited partners as general partners with general liability when it is shown that they have taken part in control of the partnership.¹³ The court acknowledged that in the instant case limited partners in fact controlled the day-to-day operations of the limited partnership.¹⁴ However, the court refused to find that they were generally liable for two reasons. First, the limited partners had acted as agents for their corporate principal and not in their individual capacities. "In the eyes of the law" it was the corporation and not

9. The universally cited general formulation of the doctrine is as follows:

If any general rule can be laid down, in the present state of authority, it is that a corporation will be looked upon as a legal entity as a general rule, and until sufficient reason to the contrary appears; but, when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime, the law will regard the corporation as an association of persons.

United States v. Milwaukee Refrigerator Transit Co., 142 F. 247, 255 (C.C.E.D. Wis. 1905). See generally 1 W. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* §§ 41-46 (rev. vol. 1974); H. HENN, *supra* note 1, at § 146.

10. "If a corporate general partner is inadequately capitalized, the rights of the creditor are adequately protected under the 'piercing-the-corporate-veil' doctrine of corporation law." 88 Wn. 2d at 404, 562 P.2d at 247.

11. "When the shareholders of a corporation, who are also the corporation's officers and directors, conscientiously keep the affairs of the corporation separate from their personal affairs, and no fraud or manifest injustice is perpetrated on third persons who deal with the corporation, the corporation's separate entity should be respected." *Id.* at 405, 562 P.2d at 247.

12. *Id.*

13. See note 4 *supra*.

14. 88 Wn. 2d at 401, 562 P.2d at 245.

its agents which controlled the limited partnership.¹⁵ Second, because the limited partners had "scrupulously separated their actions on behalf of the corporation from their personal actions," the creditor never assumed that they were general partners with general liability.¹⁶

II. INTERPRETING THE CONTROL PROVISION OF THE LIMITED PARTNERSHIP STATUTE

A. *The Recent Amendment to the Control Provision*

In thus approving de facto control by limited partners, *Frigidaire Sales* overthrows the longstanding policy of requiring forfeiture of control as quid pro quo for limited liability in the limited partnership.¹⁷ This result was achieved not only without legislative sanction but in the face of a recent revision of the limited partnership statute which evidenced a legislative policy of permitting only a very narrow range of limited partner activity.¹⁸ The revised control restriction provides that a limited partner's right to vote upon matters affecting the basic structure of the partnership, including transfer of a majority of the voting stock of a corporate general partner, does not amount to participation in control.¹⁹ Nowhere did the legislature suggest that limited partners may control a corporate general partner, either

15. *Id.* at 405, 562 P.2d at 247.

16. *Id.*

17. The Texas Supreme Court so strongly resisted this result that it suggested limited partner control through a corporate general partner would justify piercing the corporate veil to impose personal liability because under such circumstances the corporation is used to circumvent the limited partnership statute. *Delaney v. Fidelity Lease Ltd.*, 526 S.W.2d 543, 546 (Tex. 1975).

18. WASH. REV. CODE § 25.08.070 (1976).

19. The statute provides,

A limited partner shall not be deemed to take part in the control of the business by virtue of his possessing or exercising a power, specified in the certificate, to vote upon matters affecting the basic structure of the partnership, including the following matters or others of a similar nature: (a) Election, removal, or substitution of general partners, including, but not limited to, transfer of a majority of the voting stock of a corporate general partner. (b) Termination of the partnership. (c) Amendment of the partnership agreement. (d) Sale of all or substantially all of the assets of the partnership.

WASH. REV. CODE § 25.08.070(2) (1976).

through ownership or management,²⁰ or that the restriction on limited partner control was to be ineffective against limited partners who are officers in the corporate general partner. If the legislature had intended such a sweeping change in the effect of the statute, it could have stated so expressly.

B. *The Texas Interpretation Compared with the Rule of Frigidaire Sales*

Under the *Frigidaire Sales* approach, if a limited partner is an officer of the corporate general partner, the limited partner's participation in control of the partnership becomes irrelevant. The creditor who fails to obtain a personal guarantee²¹ is denied a personal recovery unless he can demonstrate some equitable ground for recovery. This approach is flatly opposed to the position taken by the Texas Supreme Court in *Delaney v. Fidelity Lease Ltd.*,²² in which the court stated that personal liability would be imposed on limited partners exercising control of the partnership in any capacity. In that case, the limited partners' status as corporate officers²³ and the question of creditor reliance²⁴ were held irrelevant to the determination of statutory liability.

20. Since "control" is not defined in the statute, the task of determining what acts amount to control has been left to the courts. Cases confronting this problem are summarized and discussed in BROMBERG, *supra* note 1, at 147; Feld, *The "Control" Test for Limited Partnerships*, 82 HARV. L. REV. 1471 (1969); Comment, "Control" in the Limited Partnership, 7 J. MARSHALL J. OF PRAC. AND PROC. 416 (1974). See also Coleman & Weatherbie, *Special Problems in Limited Partnership Planning*, 30 SW. L.J. 887, 897-906 (1976).

21. The court emphasized that contract claimants have the ability to protect themselves prior to breach: "If petitioner had not wished to rely on the solvency of Union Properties as the only general partner, it could have insisted that respondents personally guarantee contractual performance." 88 Wn. 2d at 406, 562 P.2d at 247.

22. 526 S.W.2d 543 (Tex. 1975). See note 6 *infra*.

23. The *Delaney* court justified its attitude toward officer status as follows: Assuming that Interlease Corporation was a legal general partner, . . . this would not prevent [the corporate officers] from taking part in the control of the business in their individual capacities as well as their corporate capacities. In no event should they be permitted to escape the statutory liability which would have devolved upon them if there had been no attempted interposition of the corporate shield against personal liability. 526 S.W.2d at 546.

24. The court noted that the control restriction "simply provides that a limited partner who takes part in the control of the business subjects himself to personal liability as a general partner. The statute makes no mention of any requirement of reliance on the part of the party attempting to hold the limited partner personally liable." *Id.* at 545.

The choice between the two interpretations is the choice between a formal and a nonformal rule.²⁵ Under *Delaney* the imposition of liability may seem arbitrary because there is no investigation into underlying equities. At the same time, this feature imports the advantage of ease of judicial administration and makes results more predictable for both planners and litigants.²⁶ On the other hand, the equitable approach of *Frigidaire Sales* is superficially appealing because its flexibility may enable courts to identify the offending party.²⁷ However, a close examination of the courts' experience with the equitable theories offered reveals that those theories operate to impose liability only on the very careless. Wary limited partners should be able to avoid the burden of personal liability even when they have established and control a thinly capitalized enterprise.

C. *The Difficulty of Establishing Personal Liability under Frigidaire Sales*

A creditor seeking to establish personal liability by piercing the corporate veil is first met by the general rule that the corporate entity is to be respected except in extraordinary circumstances.²⁸ The *Frigidaire Sales* opinion suggests that a finding of undercapitalization qualifies as such an extraordinary circumstance. Although commentators have suggested that undercapitalization justifies disregard,²⁹ a search of the reported decisions reveals no instance in which an American court has grounded disregard solely on a finding of inadequate capitalization. There is no precedent in Washington, but courts in other jurisdictions have treated inadequate capitalization as merely

25. See generally Powers, *Formalism and Nonformalism in Choice of Law Methodology*, 52 WASH. L. REV. 27 (1976); Note, *Jurisdiction—A Methodological Analysis: Implications for Presence and Domicile as Jurisdictional Bases*, 53 WASH. L. REV. 537 (1978).

26. Of course, the problem of determining what acts amount to control remains. See note 20 *supra*.

27. It should be noted that the court implies that the same equitable approach would be adopted in cases involving limited partnerships comprised solely of individual partners. See note 34 *infra*.

28. See 1 W. FLETCHER, *supra* note 9, § 41; H. HENN, *supra* note 1, § 46.

29. See, e.g., H. BALLANTINE, *BALLANTINE ON CORPORATIONS* § 129 (1946); 1 W. FLETCHER, *supra* note 9, § 44.1. A presumption that this doctrine provides real protection for creditors underlies approval of the *Frigidaire Sales* approach in Coleman and Weatherbie, *supra* note 20, at 902.

one factor to be considered in the decision to disregard.³⁰ Judicial statements that inadequate capitalization alone is insufficient to support disregard are numerous.³¹ Furthermore, the instant case provided a prime opportunity for the court to apply an undercapitalization test. The court's failure to remand or make any inquiry into the capitalization of the corporate general partner scarcely portends energetic application of the doctrine.

The opinion reiterates the well-established doctrine that the corporate entity may be disregarded where the affairs of the corporation and the personal business of an individual controlling it become so intermingled that failure to disregard would result in fraud or injustice.³² This doctrine has been employed to pierce the corporate

30. Inadequate capitalization has most often been considered in decisions to disregard when the controlling individuals of the corporation have failed to maintain it as an institution with a life independent of their own activities, thus warranting application of the "alter ego doctrine" and the court's decision to disregard. *See, e.g.,* *Minton v. Cavanaugh*, 56 Cal. 2d 576, 364 P.2d 473, 15 Cal. Rptr. 641 (1961); *Shafford v. Otto Sales Co.*, 149 Cal. App. 2d 428, 308 P.2d 428 (1957). The cases are discussed in Annot., 63 A.L.R.2d 1051 (1959). One commentator has suggested that inadequate capitalization is the major factor in cases that involve both the alter ego doctrine and inadequate capitalization:

The cases consistently say that inadequate capitalization by itself is not a sufficient ground upon which to find alter ego. Nonetheless, inadequate capitalization seems to be the rationale most cited when the corporate veil is pierced. Admittedly, other reasons are always found, but these reasons seem to evolve from the factor of inadequate capitalization.

Grossman, *Alter Ego: A Perplexing Doctrine*, 51 L.A.B.J. 233, 236 (1975). Inadequate capitalization may be the rationale most cited because it is almost always present in these cases. When a corporation possesses funds sufficient to pay its debts plaintiff has little incentive to seek disregard of the corporate entity.

One should not confuse the courts' equitable power to disregard the corporate entity in order to impose general personal liability with equitable power to characterize a "debt" as a capital contribution when persons establishing a corporation make a nominal loan of assets or cash to the corporation while establishing a relatively small nominal capital contribution. Creditors stand a better chance of success in the latter case. The result in such cases is that insider claims to corporate assets are subordinated to the claims of outside creditors. *See, e.g.,* *Pepper v. Litton*, 308 U.S. 295 (1939); *Arnold v. Phillips*, 117 F.2d 497 (5th Cir. 1941). *Arnold* is discussed in N. LATTIN, *THE LAW OF CORPORATIONS* § 15 (1971), as a case involving disregard of corporate entity.

31. *See, e.g.,* *Dewitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co.*, 540 F.2d 681, 687 (4th Cir. 1976); *Arnold v. Browne*, 27 Cal. App. 3d 386, 103 Cal. Rptr. 775, 783 (1972); *North Arlington Med. Bldg., Inc. v. Sanchez Construction Co.*, 471 P.2d 240, 244 (Nev. 1970).

32. *See generally* 1 W. FLETCHER, *supra* note 9, § 41.1; Corrigan and Schirott, *Piercing the Corporate Veil: Dispelling the Mists of Metaphor*, in TRIAL LAWYERS GUIDE 121 (J. Kennelly ed. 1973); Grossman, *supra* note 30. Washington courts have sometimes found opportunity to approve the doctrine in cases (such as *Frigidaire Sales*) in which the corporate veil was not actually pierced. *See* *Seattle Ass'n of Credit Men v. Daniels*, 15 Wn. 2d 393, 396, 130 P.2d 892, 894 (1942); *Von Herberg v. Von Herberg*, 6 Wn. 2d 100, 114-15, 106 P.2d 737, 743-44 (1940); *Garvin v. Matthews*, 193 Wash. 152, 156-57, 74 P.2d 990, 992 (1938); *Nursing Home Bldg. Corp. v. DeHart*, 13 Wn. App. 489, 496, 535 P.2d 137, 142 (1975). Washington courts have also employed the doctrine

veil only in cases of clear abuse of the corporate form and should create no danger for the limited partner who controls a corporate general partner whose independent identity is formally maintained.³³

The court's interpretation of the limited partnership statute suggests that if a limited partner is acting as the agent of a corporate general partner, the statute mandates only that the limited partner may be held personally liable in cases in which he has led the creditor to believe that he is a general partner with general liability.³⁴ Thus interpreted, the statute appears to add nothing to general principles of estoppel.

D. *Undesirable Effects of the Frigidaire Sales Interpretation*

It is undesirable that a person with both a limited partner's interest and a controlling interest in the corporate general partner be allowed limited liability because tax considerations will ordinarily persuade

to impose personal liability. *Kueckelhan v. Fed. Old Line Ins. Co.*, 69 Wn. 2d 392, 410-12, 418 P.2d 443, 456 (1966); *J.I. Case Credit Corp. v. Stark*, 64 Wn. 2d 470, 478, 392 P.2d 215, 220 (1964); *Superior Portland Cement, Inc. v. Pacific Coast Cement Co.*, 33 Wn. 2d 169, 212-16, 205 P.2d 597, 620-22 (1949); *Cooper & Co. v. Anchor Securities Co.*, 9 Wn. 2d 45, 69-70, 113 P.2d 845, 856 (1941); *National Bank of Commerce of Seattle v. Dunn*, 194 Wash. 472, 500, 78 P.2d 535, 547 (1938); *Roberts v. Hilton Land Co.*, 45 Wash. 464, 468, 88 P. 946, 947 (1907); *Burns v. Norwesco Marine, Inc.*, 13 Wn. App. 414, 418-20, 535 P.2d 860, 862-64 (1975).

33. Factors a court may consider in determining whether a corporation has maintained an independent identity include a) segregation of the funds of the corporation from those of the controlling person(s) or entity, b) diversion of corporate funds to non-corporate uses, c) use by individuals controlling the corporation of corporate assets as their own, d) maintenance of adequate corporate records, e) use of the same business location and/or employees by more than one entity, and f) diversion of corporate assets to another entity to the detriment of creditors. Grossman, *supra* note 30, at 234.

34. 88 Wn. 2d at 405, 562 P.2d at 247. The reliance interpretation of the control provision, UNIFORM LIMITED PARTNERSHIP ACT § 7 (act withdrawn 1976), was first advanced in Feld, *supra* note 20. See also Coleman and Weatherbie, *supra* note 20, at 899. The court cited the Feld article in support of its statement that the limited partners should not be liable because the creditor did not rely on their acts in control to assume they were general partners. 88 Wn. 2d at 405, 562 P.2d at 247. However, Feld's argument does not support an "actual reliance" interpretation of the control provision: "[O]nly activities which conceivably could induce reasonable reliance, such as supervision of the partnership's day-to-day activities, should produce general liability." Feld, *supra* note 20, at 1479. Thus, even under the Feld reliance interpretation of the control provision, personal liability would have been established in *Frigidaire Sales*.

The Revised Uniform Limited Partnership Act adopts a limited "actual knowledge" standard: "But [if] the limited partner's participation in the control of the business is not substantially the same as the exercise of the powers of a general partner, he is liable only to persons who transact business with the limited partnership with actual knowledge of his participation in control." REVISED UNIFORM LIMITED PARTNERSHIP ACT § 303(a) (emphasis added).

Limited Partner Control

her to put the bulk of her funds into limited partner units,³⁵ leading directly to undercapitalization of the corporate general partner. Adoption of the *Delaney* approach would have the twin effects of discouraging limited partners from participating in control and inducing those who do so to exercise control prudently. Controlling partners would know that their personal assets insured the debts of the enterprise and would therefore be more likely to manage cautiously. Furthermore, they would consider their potential exposure to personal liability prior to assuming the positions of limited partner and controlling investor or officer of the corporate general partner. *Frigidaire Sales'* removal of the threat of personal liability enables a controlling limited partner to become an excessive risk taker.

The limited partnership has become the most common vehicle for the tax shelter investment.³⁶ Tax shelters are inherently risky for various reasons. Tax shelter investors are usually individuals of high income motivated to enter a shelter by the desire to reduce tax liability on income from other sources. They are likely to make riskier investments than others because their potential net loss (the loss of money

35. Since the corporation is an independent tax-paying entity, I.R.C. § 11, to the extent that an investor's funds are allocated to shares in a corporate general partner rather than in directly held partnership units, partnership losses can not be passed through to the investor to reduce tax liability on income from other sources. Furthermore, if the partnership generates and distributes a profit, it will be taxable at the corporate level before reaching the investor as shareholder in the corporate general partner. Income attributable to direct ownership of a partner's interest is not subject to such double taxation. See note 36 *infra*.

Where one corporation serves as a general partner for more than one limited partnership, another motive for allocation of funds to limited partner units rather than to the corporate general partner appears: the corporate general partner's assets are subjected to potential liability from the failure of any of the limited partnerships in which it participates. A limited partner's investment is lost only if the home partnership fails.

36. According to a congressional report, "The form of entity most commonly chosen to maximize tax benefits in a tax shelter investment has been the limited partnership." STAFF OF JT. COMM. ON INT. REV. TAX., 95TH CONG., 1ST SESS., 1 TAX REVISION ISSUES—1976, at 7 (Comm. Print 1976) (description of H.R. 10612) [hereinafter cited as STAFF REPORT ON TAX SHELTERS]. At least one commentator has stated that the terms "limited partnership" and "tax shelter" have become synonymous. Stiss, *Limited Partnerships: the IRS Attack on Tax Shelters*, 6 TAX ADVISER 659, 659 (1975). Limited partnerships ideally serve the tax shelter investor because, in addition to the privilege of limited liability and the absence of income taxation at the partnership level, I.R.C. § 701, limited partners are allowed to utilize their proportionate share of partnership losses as tax deductions, thus reducing tax liability on income from other sources. I.R.C. § 702(a). Partnership "losses" for the purpose of determining tax deductions are inflated through rapid depreciation of partnership assets.

The Tax Reform Act of 1976, Pub. L. 94-455, 90 Stat. 1520 (1976) (codified in scattered sections of I.R.C.), struck at the heart of many limited partnership tax shelters with its "at risk" limitation on the extent to which limited partners may increase their basis to reflect partnership borrowing. An investor may not take tax deductions for partnership

reduced by the tax deduction produced by such loss) is less.³⁷ More importantly, the tax shelter is risky because it is usually highly leveraged in order to maximize tax deductions per dollar invested.³⁸

III. CONCLUSION

The court in *Frigidaire Sales* was faced with the problem of allocating the risk created by a limited partnership which was ultimately unable to pay its debts. The drafters of the Uniform Limited Partnership Act intended that limited partners taking part in control of a limited partnership as well as nominal general partners should bear the risk of

losses in excess of her adjusted basis in the investment. Formerly, investors were allowed to increase their basis to reflect partnership nonrecourse financing. In many cases, investors have been provided with tax deductions in an amount greater than their out-of-pocket investments, without personal liability for the loans which made this possible. Under the 1976 revision, an investor may not increase her basis to reflect partnership borrowing for which she is not personally liable ("at risk"). I.R.C. §§ 465, 704(d). Significantly, organizations whose principal activity is investing in real property are exempt from this provision. I.R.C. § 704(d). On the general impact of the 1976 amendments, see generally SENATE FINANCE COMM. REP., TAX REFORM ACT OF 1976, S. REP. NO. 94-938, 94th Cong., 2d Sess. (1976); Dailey and Gaffney, *Anatomy of a Real Estate Tax Shelter: The Tax Reform Scalpel*, 55 TAXES 127 (1977).

Determination of corporate or partnership status for tax purposes is made under the "Kintner regulations." Treas. Reg. §§ 301.7701-2, -3, regardless of the classification under state law. The regulations are treated extensively in Note, *Tax Classification of Limited Partnerships: The IRS Bombs the Tax Shelters*, 52 N.Y.U.L. REV. 408 (1977) [hereinafter cited as *Tax Classification*]. See also STAFF REPORT ON TAX SHELTERS, *supra* at 108-09; Comment, *The Limited Partnership as a Vehicle for Syndicated Real Estate Investment: Selected Tax Considerations*, 1973 WIS. L. REV. 1124, 1126-37. The regulations were designed to prevent professional organizations from taking advantage of corporate tax status and were therefore weighted in favor of finding partnership status. They have "had the unintended effect of virtually guaranteeing the desired partnership tax status to the limited partnership tax shelters." *Tax Classification*, *supra* at 417-18. The IRS has diligently attempted to overcome this bias in its regulations. For example, in *Larson v. Comm'r*, 66 T.C. 159 (1976), *appeal dismissed per stipulation*, No. 77-1056 (9th Cir. Jan. 18, 1978), and *Zuckman v. United States*, 524 F.2d 729 (1975), IRS denials of partnership status were overruled. The IRS proposed amendments to the regulations in January 1977, which would classify most tax shelters as associations rather than partnerships. "The Treasury Department immediately withdrew these proposals, apparently in response to a storm of protest from real estate interests and the Department of Housing and Urban Development." *Tax classification*, *supra* at 410 (footnote omitted).

37. See STAFF REPORT ON TAX SHELTERS, *supra* note 36, at 5.

38. According to one commentator, "In the typical real estate tax shelter the majority of partners (i.e., the limited partners) make relatively small capital contributions; all other necessary financing is obtained through the issuance of debt." Davies, *The Administrative Assault Upon the Real Estate Tax Shelter*, 54 TAXES 505, 508 (1976). On the importance of leveraging in the creation of a tax shelter, see generally STAFF REPORT ON TAX SHELTERS, *supra* note 36, at 5-6; Perry, *Limited Partnerships and Tax Shelters: The Crane Rule Goes Public*, 27 TAX L. REV. 525 (1972); Stiss, *supra* note 36, at 663; Comment, *The Limited Partnership as a Vehicle for Syndicated Real Estate Investment: Selected Tax Considerations*, 1973 WIS. L. REV. 1124, 1143-46.

the possibility of a partnership failure.³⁹ Protection of parties dealing with the enterprise was guaranteed by the personal assets of persons in control. This keystone to the structure of the limited partnership was jolted when corporations began to take positions as general partners. Greater protection would be accorded creditors by a statutory requirement that a corporate general partner be capitalized at a level sufficient to satisfy prospective partnership liabilities. At present no such statutory requirement exists. If defining appropriate minimum capitalization levels proves impossible, state legislatures should ban corporations from the role of general partner in the limited partnership. Whatever the social utility of the corporation in other contexts, it is clear that the only function it served in *Frigidaire Sales* was to shield persons in control from personal liability and thus to destroy a fundamental attribute of the limited partnership form.

Lawrence Repeta

39. The limited partnership form was originally cast in a mold shaped by the common law prejudice against limited liability. The courts looked upon even minor deviations from statutory requirements as causing forfeiture of the privilege of limited liability. See Crane, *Are Limited Partnerships Necessary?*, 17 MINN. L. REV. 351, 353-55 (1933); Lewis, *The Uniform Limited Partnership Act*, 65 U. PA. L. REV. 715, 719-20, 724 (1917); *The Limited Partnership Act*, *supra* note 1, at 895-99 (1936). The Uniform Limited Partnership Act greatly relaxed the standard of scrutiny; for example, it provided that substantial compliance in good faith with the requirements for a limited partnership certificate was sufficient to bring the limited partnership into existence and thus protect its limited partners from personal liability. UNIFORM LIMITED PARTNERSHIP ACT § 2(2) (act withdrawn 1976); WASH. REV. CODE § 25.08.020(2) (1976). However, the earlier statutory restrictions on limited partner "interference" were reenacted as a restriction on limited partners taking part in control. A drafter of the Uniform Limited Partnership Act pointed out that an investor in a limited partnership was in a position superior to that of a corporate shareholder because the limited partner's investment was being managed by people with general liability for the debts of the enterprise, thus insuring their best effort. Lewis, *supra* at 717. The business public gained the same assurance that limited partnerships were well managed. Should a partnership fail, persons in control would be held liable because they would be responsible for the impairment of the creditors' security. Comment, *Partnership: Can Rights Required to be Given Limited Partners under New Tax Shelter Investment Regulations Be Reconciled with Section 7 of the Uniform Limited Partnership Act?*, 26 OKLA. L. REV. 289, 293 (1973).